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Principles of Islamic Finance

Consider for a moment about operating and practicing law in a jurisdiction and under a financial system where there is no separation between church and state. Most if not all of us operate in a western oriented system where the banking and financial systems operate laissez-faire, with minimal government interference and certainly little if any religious interference or control.

Certainly, many of us who are Americans take for granted the notion of separation of church and state. Not so with regard to the subject of this paper - Islamic based financing. Like many of you, I operate in a law firm that concentrates in financial service matters. At Tannenbaum Helpern, we represent numerous hedge funds, insurance companies, banks, fund sponsors, investment advisors. And the list goes on. A segment of the practice is related to funds which are designed for sale into the Islamic regions of the world, for consumption by investors who strictly follow the tenets of Islam, and the teachings of the Koran.

In this area, there is no separation of church and state – the financial system is very much controlled by and operated in accordance with Islamic principles of finance, not western principles of finance. And this means the hedge funds and deals in general are structured to fall within the strict teaching of Islamic religious principles, in adherence with the so called Shari'ah, meaning "the way." So, this paper is necessarily a discussion that is more grounded in

In this issue:

To Our Clients and Friends:

There are several regions of the world that require specific knowlege in designing investment products. The U.S., for example, certainly has all sorts of regulations with which to comply, as does each state. Foreign countries have their own rules as well.

One region that holds particular challenge is the Islamic regions, namely the Middle Eastern countries and Southeast Asia. In these areas the religious rules govern the others. In designing investment products, therefore, it is essential to have an understanding of the basic principles of Islamic finance.

We hope you enjoy this ***special focus report GlobalNote.*** which is devoted entirely to those basic principles. Please call for further information about how this topic might apply to you. We can assist in developing investment products for this region.

Sincerely,

Michael G. Tannenbaum

the tenets of the Koran than the Magna Carta, but in that distinction lies the intellectual stimulation.

Why is this important to those of us who practice law in the area of financial services?

As the bank robber Willie Sutton said as to why he robs banks: That's where the money is. Since the great growth over the last 30 years or so of the oil dollars in the regions of the world that adhere to Islamic principles, that's where one of the next real explosions of fund growth must occur. The market for funds and financial products that comply with the Shari'ah is enormous and growing constantly. If one or more of your clients is a bank or fund sponsor, the subject will come up, sooner than later. Many sponsors and advisers are gravitating towards Islamic regions for investors because that's where so much money is these days.

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According to one report, Muslims account for about 1/5th of the worlds population. It is said that in the last 20 years, the system of Islamic banking and finance has grown to over 100 billion dollars.

OPEC started in about 1959. The Jedda based Islamic Development Bank was founded in 1975. Russia's Meshkombank was established in Kazakstan in 1996, and in the same year, the Islamic Bank for Finance and Investment was established in Yemen. Citibank followed suit with the City-Islamic Investment Bank. ABN AMRO followed and the list goes on. Goldman Sachs through J. Aron in London is a major player in this area. Kleinwort Benson is active. Some analysts put the growth in the region at about 15 to 20% per year. The list goes on and on and the evidence is perfectly clear that this region is important and that these principles are to be understood by the financial community at large and by us as lawyers.

What are the rules of the game? What are the general principles?

Structurally, the Islamic based mutual fund looks like any other with one exception: the presence of an adviser called a Shari'ah Advisor, i.e. the consultant, if you will, that gives the advice regarding the investments and financial activity that can and can not be made by the fund. Accordingly, the role of the Shari'ah adviser is essential: to determine the intrinsic financial aspects of the proposed transaction and the religious laws related to it.

The real starting point: the prohibited enterprises

Islamic principles established by the Shari'ah advisor will differ from advisor to advisor, as some are more liberal and others are more conservative; as in any religion or philosophy. By the way, one of the major issues facing the issuers of products to be sold to this community of investors is this diversity among Shari'ah scholars. They may be unanimous on the fundamental principles but the interpretation can be varied. Generally, there is agreement about the following broad set of prohibitions: manufacturing, packing or distribution of alcohol or pork products for human consumption; gambling casinos or the manufacture of gambling machines; movie theaters; pornography; hotels; financial services, including banks, insurance companies, brokerage firms; charging or paying of interest - more about this particular prohibition below; restaurants that derive their core revenue from the sale of alcohol; and airlines are generally a problem because a substantial part of their revenue of such companies is from alcohol sales, and duty free sales of tobacco.

The prohibition against the charging of interest - riba

It is a basic tenet of Islamic banking that all interest – charging it or receiving it – so called *riba*, is outlawed. And this is true, whether the interest is usurious or not. It is central to Islamic financial philosophy that money and capital be used for the central good of the community, that it be invested to create jobs and well being. The theory goes that the owner of wealth is merely a custodian of the value it represents.

Money must be put to practical use in creating real value for the participants of the transaction. It must be used to create, and not be a commodity in on and of itself. It because of this that the perception of hoarding capital, and the earning of a passive return on capital keyed to the passage of time, - i.e. interest – is prohibited. In short, money must not be made from money.

Because ***riba*** represents a reward for holding money, rather than the employment of capital for the greater good, it is prohibited. This is the central underpinning of much that follows and impacts the entire banking system. This means no late charges, this means no receivable financing, and so on. Banks, for example, do not pay interest on deposits but rather share profits derived by the bank in its allowable investments using the capital supplied by the depositors with those depositors.

Dividend cleansing

It is not difficult to recognize that if investments are limited to only those companies that do not engage in any of the prohibitions enumerated, companies that do not pay or receive interest, essentially totally non-leveraged operations, that any true investment activity would simply be impossible in today's world. At least in today's *western* world. That led to a compromise based on the principles of necessity. This was announced in The Joint Declaration of July 1987, an interpretation to the effect that investment in an otherwise prohibited area might be acceptable if it represents only a minor proportion of the income from the investee company. That income is then purified through the computation of an amount representative of the tainted income and a proportionate amount of the resulting profits donated for charitable purposes.

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As a result, the Islamic banking community has devised a complex set of procedures to cleanse the income from the prohibited activities. This is known as *dividend cleansing*. The investment advisor usually establishes a set of filters in conjunction with the Shari'ah advisor to quantify the degree of prohibited activities.

This approach led quickly to the use of investment funds keeping track of the amount of profit that can be traced to activities otherwise prohibited and donating that percentage of the profits to charities. The author is familiar with funds which invest in otherwise prohibited companies provided their interest income does not exceed 15% of net revenues, or whose outstanding total debt does not exceed 30% of the market value of the equity. As to such companies , the dividend cleansing approach is used. And here again, these restrictions vary from advisor to advisor depending on the level of conservatism of the Shari'ah advisor. In drafting a prospectus of information memorandum, these kinds of things will typically be disclosed to give the investor the final decision.

So much for things that are

prohibited. What can these funds do? Leasing and installment sales transactions are two of the favorites.

A few words about leases or "Ijara."

Leases – called ***Ijara*** – form a significant area of growth in the Islamic world and funds that are involved in leasing are growing.

Under the terms of an Ijara transaction, the investor – or the lessor – will purchase the equipment from a manufacturer and lease it to the user, or lessee, for an agreed upon period of time and price. Purchase options are generally used. The amount of the payment to be made at the end of lease term may be nominal or may be substantial. These are familiar to western lawyers. But there are differences that are important.

Differences between an Islamic Lease and a Western Lease.

The major differences include: 1. The lease payments can only commence after the delivery of the asset and not before. 2.Title remains in the lessor, not the lessee.3. In a conventional lease, the risk of loss can be assigned as the parties agree. But in an Islamic lease, the risk of loss remains with the owner – i.e. the Lessor – unless the loss is caused by the negligence of the lessee. Default therefore generally means a claim for compensatory damages which is acceptable. Insurance is possible but even insurance presents Islamic issues. 4. Maintenance payment obligations are generally with the lessee although there are some commentators that say that the maintenance is an attribute of the asset so should remain with the lessor. 5. Lease payments are not to be made under an Islamic lease if the asset is destroyed or some other intervening event preventing enjoyment occurs. Western leases would have much to say about this issue. 6. Late payment penalties are a form of interest if keyed to the passage of time so is prohibited in the Ijara. 7.Lease assignments of just the rental stream by the lessor is not permitted because the rental stream is an asset and property right that is not severable from the asset itself so can not be assigned without assigning the "tree" as well as the "fruit." Nonetheless, those of us who view leases as financing substitutes ought to readily see that these arrangements can be fruitful areas of investigation when operating within the Islamic financial limitations.

> "So much for what is prohibited. What can these funds do? Leasing - ***Ijara transactions*** - and installment sales transactions are two of the favorites."

Installment sale transactions: Murabaha

Another area for funds is involvement in installment sales transactions (the so called "***Murabaha***" transactions).

This is one of the most popular and tried and true aspect of Islamic financing the Murabaha agreement or transaction to finance the acquisition of goods or real estate. In the Western system, a bank lends funds to a purchaser, secured or not by the goods acquired. The customer uses the borrowed funds to purchase the asset. The loan is then repaid plus a stated interest rate constituting the return to the bank on the loan.

Because interest is forbidden in the Islamic-banking world, a different procedure is followed.

Within a Murabaha agreement, a bank (or other capital source such as an investment fund) will fund the purchase of a given asset by charging a mark up for the goods. In other words, rather than advance the money to a borrower, which is how the system would work in a conventional Western setting, the bank would actually buy the goods from the third party seller first and then sell the goods to the customer for a predetermined price in a second separate transaction. Murabaha therefore involves the sales of goods against a deferred payment price.

In Western terms, the Murabaha transaction is a contract of sale with a deferred purchase price. It is the simplest form of "cost plus financing."

This kind of deal has its

unique set of problems. Because it is a basic element of Islamic finance that one cannot enter into a contract to sell that which it does not own, the Murabaha transaction consists of a sales contract that is entered into by the Islamic bank and the seller of the commodity *followed by* a promise between the customer and the bank to purchase of the article by from bank.

Consider the steps:

1.The customer determines the specifications of the commodity it wishes to acquire and requests the bank to purchase the asset and thereafter sell it to the customer for the cost plus a profit element. 2. The customer enters into a *non-binding* promise to purchase the commodity from the bank. (Remember that it must be non-binding at this point because the bank is not yet the owner and it can not sell that which it does not own.) 3.Assuming the bank is willing to proceed, it will then notify the seller that it wishes to purchase the asset and the seller agrees to sell to the bank. 4. The bank authorizes the customer to receive the commodity directly from the seller, thereby avoiding the issue of the bank taking the goods and then delivering goods that might not be conforming to the customer's specifications. Therefore in the Murabaha transaction, the customer also acts as the bank's agent. 5.The customer accepts delivery. 6.The bank and the customer then sign the Murabaha agreement and installment payments are then made.

The major issue here from a legal point of view is the nonbinding nature of the initial interplay between the customer and the bank. There is an enormous amount of trust involved.

Also, because in a Murabaha transaction the bank will be in the chain of title, various liabilities flow. For example, if the bank for a real estate transaction uses the Murabaha transaction, all of the difficulties arising in connection with environmental issues will exist and be imposed on the bank. Indemnities – themselves a difficult topic in the Islamic world – are needed. Maybe a special purpose vehicle will be used to protect the bank against these liabilities. Warranties and chain of title issues also exist and must be dealt with.

> "Much of the Islamic finance system is based upon due principles of profit sharing, risk sharing and partnership between individual and institutions."

And what about defaults on the payments? If the buyer defaults, the unpaid installments may be accelerated. All remaining installments would then become due and payable. The problem is that the Murabaha contract can not provide for the payment of late fees keyed to the passage of time. This would be interest. A fixed dollar amount or a percentage to the unpaid installments can be charged; but not keyed to time.

Many Murabaha contracts require the defaulting party to pay damages equal to the amount of loss sustained by the other party (reciting common law principles.) And if the lump sum payment added by virtue of default constitutes a penalty, the possibility of lack of enforceability increases.

Profit sharing arrangements

Much of Islamic society and in particular the Islamic finance system is based upon due principles of profit sharing, risk sharing and partnership between individual and institutions. It is more akin to a purely equity based financial system than many in the West but with many more techniques and methods of finance than just equity securities. For this reason, Islamic banking has become known as *profit banking*.

Joint ventures, in which each partner shares in the profits and losses is preferred. There is no guaranteed rate of return; there is only a profit sharing arrangement and there is a possibility of loss. These kinds of arrangement are called "Mudaraba transactions."

In the Mudaraba transaction, an entrepreneur is matched with the assets to invest in active projects, either generally as in a blind pool or in a special purpose vehicle of some sort. If interests are to be traded, the interests can not be financial assets; must be

tangibles. For this reason, these kinds of deals often represent traditional equity or venture capital deals.

The most common form of Mudaraba is one in which different shareholders can have different rights and profit shares, reflecting the different contributions made by each. Losses are shared on the same basis.

In terms of our western financial services industry, it is this kind of transaction that lays the favorable underpinning for Islamic participation in partnerships and hedge funds and the like. It is permissible to form a partnership in which one partner gives money to another to invest in a commercial venture. The manager may receive a profit share as return for its investment advice. This is where the classical hedge fund would fall and should sound familiar to all of us.

Conclusion

There is much to be learned from the Islamic finance point of view and much that can be adapted into what would otherwise be Western types of financing. Hedge funds and other investment vehicles can readily provide the capital needed which, when structured in accordance with the principles of Shari'ah, can be profitable and serve the social good simultaneously.

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